

SMALL ISSUE INDUSTRIAL REVENUE BONDS, 1980-1982

Report

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The use of small issue industrial revenue bonds (IRBs) increased significantly in 1981 and leveled off in 1982. This report summarizes these and other developments since the publication of the Congressional Budget Office (CBO) study of small issues two years ago.¹ Based on information supplied primarily by state and local agencies, it presents revised data for 1980 and new data for 1981 and 1982 for each state.

Small issue IRBs are tax-exempt bonds that state and local governments may issue to provide financing for private firms. They may be used for a wide variety of private business purposes, but they are subject to maximum dollar limits. No state or locality may float a small issue IRB for more than \$10 million. Moreover, if the bond amount exceeds \$1 million, total capital expenditures on all of the borrowing firm's facilities within the same county or city may not exceed \$10 million for the three years before and the three years after the issuance of the bond. Unlike small issues, tax-exempt IRBs for certain special purposes set forth in the Tax Code, such as pollution control, airports, ports, convention centers, sports stadiums, and industrial parks, are not subject to any dollar limits.²

Major Trends in 1981 and 1982 and the Outlook for 1983

The volume of small issue IRBs rose from \$9.2 billion in 1980 to \$12.6 billion in 1981, a 37 percent increase. In 1982, total issues amounted to \$12.7 billion, less than a 1 percent increase over 1981. Although the 1982 total understates IRB activity, since it is based on incomplete or preliminary data for many states, it appears that growth last year was well below increases recorded in previous years (see Table 1).

The large increase in the volume of IRBs issued in 1981 is probably related to the extraordinarily high interest rates during that year. The prime rate charged by banks averaged 18.87 percent in 1981, while the index for revenue bonds averaged 12.26 percent.³ The magnitude of the prime rate and the substantial difference

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1. Congressional Budget Office, Small Issue Industrial Revenue Bonds (September 1981).
 2. Internal Revenue Code, Section 103 (b).
 3. The prime rate charged by banks is taken from Economic Report of the President (February 1983), Table B-67. The revenue bond interest rate was calculated on the basis of weekly rates published in The Weekly Bond Buyer, January 4, 1982.

TABLE 1. SMALL ISSUE IRB SALES, 1976-1982

Year	Total (In millions of dollars)	Increase from Previous Year (In percent)
1976	1,474.8	15
1977	2,169.3	32
1978	3,350.7	54
1979	7,070.1	111
1980	9,197.7	23
1981	12,592.3	37
1982	12,681.8	1

between taxable and tax-exempt interest rates probably provided an incentive for many businesses to pursue IRB financing. At the same time, the reluctance of banks to take on new commitments for IRB financing that had begun to develop dissipated in 1981, probably because high interest rates increased bank earnings. Since banks use tax-exempt paper to offset taxable income, their demand for tax-exempt bonds would increase as interest rates rise.

IRB volume leveled off in 1982 due to the recession and falling interest rates. With the economy in recession, the level of business investment in plant and equipment declined. In turn, the demand for IRB financing declined. In 1982, the average prime rate charged by banks dropped to 14.86 percent, while the overall rate on revenue bonds increased to 12.47 percent.⁴ With the decline in the prime rate, conventional financing became more affordable. At the same time, the shrinking differential between tax-exempt and taxable rates reduced the relative attractiveness of IRB financing. Some state officials thought that the volume of IRBs in 1982 would have been lower had it not been for a surge of issues in November and December. The surge appears to have resulted from efforts to beat the January 1,

4. The prime rate charged by banks is taken from Economic Report of the President (February 1983), Table B-67. The revenue bond interest rate was calculated on the basis of weekly rates published in The Weekly Bond Buyer, January 3, 1983.

1983, effective date of most of the requirements of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).⁵

Despite general feelings of uncertainty caused by the TEFRA guidelines, most development officials contacted by CBO did not anticipate major disruptions in small issue IRB programs; however, several state officials observed a decline in activity early in 1983, possibly as a result of the push to close as many projects as possible before the end of 1982. Unless a strong economic recovery is coupled with a return to high interest rates, the volume of IRB issues in 1983 is unlikely to increase significantly over 1982.

Small Issue IRBs and the Tax-Exempt Bond Market

From 1976 to 1981, small issue IRBs represented an increasingly large share of all new long-term tax-exempt issues, rising from 4 percent in 1976 to 22 percent in 1981. In 1982, the market share declined to 15 percent. Although small issues hardly grew at all in 1982, the volume of tax-exempt bonds for other purposes registered large increases, particularly bonds for water and sewer facilities, hospitals, pollution control, and housing. Total tax-exempt issues rose from \$56.6 billion in 1981 to \$86.4 billion in 1982—a 53 percent increase.

The market for long-term tax-exempt bonds is in a period of transition, and although interest rates have fallen, the relative advantage of tax-exempt financing has diminished. In the ten years before 1982, tax-exempt rates averaged 30 percent below comparable taxable rates. In 1982, tax-exempt rates were approximately 20 percent below taxable rates. The differential between interest rates for tax-exempt and taxable bonds declined for several reasons. These included a marked increase in the volume of all tax-exempt issues, a decline in institutional demand for tax-exempt bonds resulting from either lower profits or the availability of alternative means of sheltering income from taxation, and reduced individual demand for tax-exempt bonds due to tax rate cuts. Banks and insurance companies, which used to purchase two-thirds of all new issues, now purchase only one-third, while the share purchased by individuals has increased to two-thirds. The market for tax-exempt bonds can

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5. TEFRA requires IRB issuers to make quarterly reports to the Internal Revenue Service (IRS); requires an approval process involving either a public hearing and approval by an elected official or a public referendum; reduces, with certain exceptions, cost recovery deductions for IRB-financed property; eliminates the \$1 million exemption for IRBs issued as part of a larger single issue with bonds exempt under any other provision; eliminates the use of IRBs to finance certain facilities (such as golf courses and racquetball clubs); limits the average time to maturity; and repeals the exemption for IRBs after 1986.

TABLE 2. SMALL ISSUE IRB SALES IN RELATION TO TOTAL NEW, LONG-TERM TAX-EXEMPT BOND ISSUES, 1976-1982 (In billions of dollars)

	1976	1977	1978	1979	1980	1981	1982
Total Issues	35.0	46.8	49.0	48.0	54.8	56.6	86.4
Small Issues	1.5	2.2	3.4	7.1	9.2	12.6	12.7
Small Issues' Share of the Market (In percent)	4	5	7	15	17	22	15

SOURCE: With the exception of small issues, data are based on statistics compiled by The Bond Buyer.

expand if investors in lower marginal tax brackets have an incentive to purchase tax-exempt securities. This incentive is provided when the differential between tax-exempt and taxable rates narrows and the after-tax return on tax-exempt bonds increases. This, of course, also increases the cost to bond issuers and reduces the efficiency of the tax-exempt bond subsidy mechanism.⁶

6. When state and local agencies issue tax-exempt bonds, the federal government gives up revenues so that the borrower can benefit from lower interest rates. The efficiency of this subsidy depends on the share of forgone federal revenue that is passed on in the form of interest savings to the intended beneficiaries. Estimates of this share range from 50 percent to 75 percent of total revenue losses. The remainder goes to underwriters, lawyers, and other intermediaries (including state or local bond issuing authorities), whose services are necessary to arrange tax-exempt financing, and to bondholders, who receive a higher yield on tax-exempts than is necessary for them to be willing to hold the bonds. The yield is higher than necessary for most bondholders because the interest rate is determined by the marginal bond buyer, who as a rule is in a lower tax bracket and thus requires a higher yield to induce him to hold tax-exempt securities. As the tax-exempt interest rate increases relative to the taxable rate, the efficiency of the subsidy decreases. The intended beneficiaries receive less interest savings, and high tax-rate bondholders receive even larger excess yields. For further analysis, see CBO, Tax Subsidies for Medical Care: Current Policies and Possible Alternatives (January 1980), p. 55, and The Twentieth Century Fund Task Force on the Municipal Bond Market, Building a Broader Market (McGraw Hill, 1976), pp. 146-51.

Small issue IRBs have usually been privately placed with banks and insurance companies. They have generally been unrated and relatively illiquid, which has given them limited demand. The recent emergence of a secondary or resale market for them, however, may remove illiquidity as an impediment to future volume increases. Banks have been divesting themselves of small issue IRBs by grouping them into packages, backing them with letters of credit, and selling the packages to tax-exempt mutual funds. Because they are backed by a bank, these packages become rated, and thus gain entry into national markets.

Regional Patterns of IRB Use

A breakdown of small issue IRB sales by region indicates that in the past two years use of the bonds has grown much more in the South and West than in the Northeast and North Central regions. From 1976 to 1980, the Northeast accounted for the largest share of total bond issues. In 1981, the Northeast, the North Central states, and the South each accounted for the same share of the total market--31 percent. The West accounted for the remaining 7 percent. In 1982, the South accounted for the largest share (38 percent) of total bond issues, followed by the Northeast (28 percent), the North Central states (27 percent) and the West (7 percent).

In 1981, all four regions showed an increase over the previous year. The Northeast showed the smallest percentage increase, 21 percent. The North Central states showed a 41 percent gain. The South experienced the largest absolute increase (close to \$1.4 billion), which represented a 54 percent increase over 1980, while the West, which lags considerably behind the other regions in IRB volume, had the largest percentage increase, 145 percent.

In 1982, the volume of IRBs increased in the South and West and declined in the Northeast and North Central regions. Largely because of the growing use of IRBs in Texas, the South posted a 17 percent increase over 1981. The volume of sales in the West rose by 5 percent, as a result of issues under newly initiated programs in California and Washington. IRB volume in the Northeast and North Central regions fell by 8 and 12 percent respectively. (For details, see Tables 3 and 4.)

Among the states, the most dramatic growth in the use of small issues occurred in Texas. In 1982, its third full year of operation, the Texas Industrial Authority reported sales of small issue IRBs in excess of \$1.2 billion, a 94 percent increase over 1981 (and a 470 percent increase over 1980). Meanwhile, the more established large issuers, Pennsylvania and Ohio, showed decreases from 1981 to 1982. In Pennsylvania, which still leads the states in total IRB issues, the volume declined by 17 percent, from \$1.9 billion to \$1.6 billion. In Ohio, sales declined by 38 percent, from \$1.2 billion to \$0.7 billion. As of 1981, Ohio was the second largest user of small issue IRBs, followed by Texas. Last year, the two states switched places. (For details see Table 5.)

All 50 states now permit the use of IRBs. Hawaii, Idaho, and Washington are the states that most recently enacted legislation allowing IRBs. Of these three, only Washington had issued IRBs as of the end of 1982.

TABLE 3. SMALL ISSUE IRB SALES BY REGION (In millions of dollars)

Region	1980	1981	1982
Northeast	3,243.8	3,921.9	3,605.5
Mid-Atlantic	2,599.9	3,019.8	2,731.5
New England	643.9	902.1	874.0
South	2,562.8	3,936.8	4,757.6
North Central	3,050.5	3,900.4	3,445.2
West	340.6	833.2	873.5
Total	9,197.7	12,592.3	12,681.8

The regional breakdown is based on the Census Bureau classifications detailed below:

Northeast	Maine, Vermont, New Hampshire, Massachusetts, Rhode Island, Connecticut, New York, New Jersey, and Pennsylvania. These states are subdivided into two areas: Middle Atlantic--New York, New Jersey, and Pennsylvania New England--Maine, Vermont, New Hampshire, Massachusetts, Rhode Island, and Connecticut
South	Maryland, Delaware, District of Columbia, West Virginia, Virginia, North Carolina, South Carolina, Georgia, Florida, Kentucky, Tennessee, Alabama, Mississippi, Texas, Oklahoma, Arkansas, and Louisiana
North Central	North Dakota, South Dakota, Nebraska, Kansas, Minnesota, Iowa, Missouri, Wisconsin, Michigan, Illinois, Indiana, and Ohio
West	Washington, Oregon, California, Montana, Idaho, Wyoming, Utah, Colorado, Arizona, New Mexico, Hawaii, Alaska, and Nevada

TABLE 4. SMALL ISSUE IRB SALES BY REGION (In percent of annual total)^a

Region	1976	1977	1978	1979	1980	1981	1982
Northeast	38	39	44	39	35	31	28
North Central	30	30	30	29	33	31	27
South	27	28	23	28	28	31	38
West	4	3	3	4	4	7	7

a. Columns may not total 100 percent because of rounding.

TABLE 5. SMALL ISSUE IRB SALES, 1980-1982 (In millions of dollars)

State	1980	1981	1982
Alabama	247.6	253.2	248.6
Alaska	0.0	133.5	129.3
Arizona	105.4	129.4	138.6 ^a
Arkansas	98.3	182.7	94.1
California	0.0	0.0	65.7
Colorado	40.3	54.0 ^b	54.5 ^b
Connecticut	96.5	138.2	333.2
Delaware	37.4	53.9	158.9
Florida	124.8	311.9	315.0 ^b
Georgia	212.5 ^b	225.9 ^b	369.8 ^b
Hawaii	0.0	0.0	0.0
Idaho	0.0	0.0	0.0
Illinois	196.4	263.2 ^b	265.8 ^b
Indiana	386.1	309.2	312.3 ^b
Iowa	131.3	162.9	164.5 ^b
Kansas	179.9	276.8	226.1
Kentucky	99.7	166.6	118.6 ^a
Louisiana	30.9 ^b	121.3	285.6
Maine	36.8	70.6	40.0
Maryland	137.2 ^b	356.2 ^b	295.1 ^c
Massachusetts	369.2	492.2	373.6
Michigan	374.2	446.7	451.2 ^b
Minnesota	415.0	545.4	545.8 ^c
Mississippi	112.6	123.3	64.3
Missouri	276.6 ^b	390.0 ^b	391.4 ^c
Montana	7.1	53.2	39.4
Nebraska	29.7	51.5	36.9 ^c
Nevada	31.0	33.8	24.8
New Hampshire	54.4	88.0	60.6
New Jersey	578.0	599.5	597.5
New Mexico	33.4	44.8 ^b	45.3 ^b
New York	382.8	531.0	565.0 ^c
North Carolina	200.0	251.1	253.6 ^b
North Dakota	38.8	46.1 ^b	44.2
Ohio	805.4	1,158.8	712.8
Oklahoma	48.9	40.3	14.4
Oregon	31.0	69.5	30.9
Pennsylvania	1,639.1	1,889.3	1,569.0
Rhode Island	63.1	62.6	55.9
South Carolina	199.2	189.6	225.0 ^d
South Dakota	21.9	43.3	43.7 ^b
Tennessee	244.5	302.6	481.2
Texas	218.8	642.1	1,248.0
Utah	55.2	299.9	302.9 ^b
Vermont	23.9	30.5	10.7 ^a
Virginia	380.7	488.7	414.1 ^c
Washington	0.0	0.0	26.8 ^a
West Virginia	169.7 ^b	227.4	171.3
Wisconsin	195.2	206.5	250.5
Wyoming	37.2	15.1 ^c	15.3 ^b
Totals	9,197.7	12,592.3	12,681.8

a. CBO projections based on six months data for 1982.

b. CBO estimate. See sources of information.

c. These numbers are based on preliminary data and do not reflect final totals.

d. CBO projection based on nine months data for 1982.

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SOURCES OF INFORMATION

CBO data on small issue IRBs come primarily from lists, documents, and reports submitted by state and local agencies. In some cases data were furnished in the course of telephone conversations with state and local officials. The sources of data are listed for each state in the following table.

As in the past, CBO has attempted to obtain and report information on small issue IRB closings--that is, those bonds actually sold. Some states could only supply data on bonds approved for issuance. In these cases, an attempt was made to determine the percentage of approvals that go to closing. If fewer than 90 percent of issues approved actually close, it has been so noted. Fortunately, most states are able to supply information based on closings or have approval processes that ensure most bonds approved go to closing.

STATE	SOURCE OF INFORMATION
Alabama	Data came from notifications filed with the Alabama Securities Commission, Montgomery. Commission staff estimate that nearly all of the issues filed eventually close. The notification procedure covers IRBs issued under eight "authorizing acts." There is no way to determine how many small issue IRBs have been issued under an additional 20 or so statutes and another 25 or so constitutional amendments.
Alaska	Data were provided by Wohlforth and Flint, legal counsel to the Alaska Industrial Development Authority.
Arizona	Aggregate data for 1981 and the first half of 1982 were obtained from the Office of Economic Planning and Development.
Arkansas	Data came from the Arkansas Department of Economic Development.
California	Data came from the Department of Economic and Business Development. California legislation permitting local issuance of small issue IRBs became effective October 1, 1980; however, no issues went to closing prior to 1982.
Colorado	The Colorado Division of Commerce and Development has not prepared a report on IRB activity since 1980. A new report is being prepared, but is not yet available. Colorado has no reporting requirement. Information is gathered on a catch-as-catch-can basis and is probably incomplete. The 1981 and 1982 figures are CBO estimates based on activity in other states.
Connecticut	Aggregate data on IRB closings were provided by the Connecticut Development Authority.
Delaware	Data came from the Delaware Development Office, the City of Wilmington Department of Commerce, and the New Castle County Department of Finance.
Florida	Annual totals are based on surveys conducted by the Florida House of Representatives Committee on Tourism and Economic Development. The 1982 figure is a CBO estimate based on activity in other states.

Georgia	Data representing between 50 and 65 percent of total IRB activity were provided by King and Spalding, a bond counsel firm in Atlanta. According to King and Spalding, the firm's share of IRB issues has declined in recent years. Consequently, CBO's Georgia (contd.) estimates assume that King and Spalding handled 65 percent of the total volume of small issues in 1980; 57 percent in 1981; and 50 percent in 1982.
Hawaii	Information concerning small issue IRBs in Hawaii was provided by the Finance Division of the Department of Budget and Finance. Although the State Constitution has permitted the use of IRBs since 1978, and enabling legislation has since been passed, no IRBs were issued prior to 1983. The approval process in Hawaii requires a two-thirds vote in the legislature.
Idaho	Idaho law permitting the use of IRBs became effective in November 1982. No IRBs were issued prior to 1983. Information was obtained from the Bureau of Economic and Community Affairs.
Illinois	Illinois data for 1980 came from a study by David R. Allardice of the Federal Reserve Bank of Chicago, "Small Issue Industrial Revenue Bond Financing in the Seventh Federal Reserve District." The 1981 and 1982 figures are CBO estimates based on activity in other states. The Federal Reserve Bank in Chicago is now collecting information on 1981 and 1982 issues from Illinois counties and municipalities.
Indiana	Data came from the Business and Financial Services Division of the Indiana Department of Commerce. The 1982 figure is a CBO estimate based on activity in other states.
Iowa	Data are from the Iowa Development Commission. The 1982 figure is a CBO estimate based on activity in other states.
Kansas	Data came from the Kansas Department of Economic Development.
Kentucky	Data are from the Commonwealth of Kentucky, Finance and Administration Cabinet, "Kentucky Local Debt Report."
Louisiana	Data are from the State Bond Commission. The 1980 figure is a CBO estimate from the 1981 IRB report.
Maine	Data come from the Maine Guarantee Authority.

Maryland	Data are from the Department of Economic and Community Development, the Maryland Industrial Development Financing Authority, and the Baltimore Economic Development Corporation. Beginning July 1, 1982, local governments were required to report IRB issues to the Department of Economic and Community Development. Thus 1982 is the first year in which accurate information on county and local IRB activity was available. The 1981 figure represents a CBO estimate, working backward from the 1982 total. The 1980 figure is a CBO estimate from the 1981 IRB report.
Massachusetts	Data were drawn from listings of IRB projects published in the Annual Reports of the Massachusetts Industrial Finance Agency.
Michigan	Michigan data for 1980 come from a study by David R. Allardice of the Federal Reserve Bank of Chicago, "Small Issue Industrial Revenue Bond Financing in the Seventh Federal Reserve District." Data for 1981 and partial 1982 data come from the Michigan Department of Commerce, Office of Economic Development.
Minnesota	Data are from the Minnesota Department of Energy, Planning and Development. Beginning in 1982, records were kept of closings. The 1982 figure reflects these closings. Prior to 1982, the only data available were based on approvals. Historically, roughly 70 percent of bond approvals actually closed. Thus, pre-1982 figures represent 70 percent of approvals.
Mississippi	Data came from State of Mississippi Department of Economic Development.
Missouri	Data for 1982 are from the Missouri Division of Commerce and Industrial Development. A reporting requirement took effect in 1982, requiring local development authorities to report IRB issues to the Missouri Division of Commerce and Industrial Development. The 1982 figure is a preliminary figure based on these reports. The 1980 and 1981 figures are CBO estimates, working backward from the 1982 number.
Montana	Montana instituted a reporting requirement as of October 1, 1981. Data before that date were provided by the Montana Department of Commerce. The State Auditor provided data for the period since October 1, 1981.

Nebraska	Data came from the Department of Economic Development. Due to the time lag between the closing of a bond issue and the registration of that issue, the data for 1982 are not complete.
Nevada	Data are from the State of Nevada Department of Economic Development.
New Hampshire	Data came from the New Hampshire Industrial Development Authority.
New Jersey	The data were obtained from the New Jersey Economic Development Authority.
New Mexico	The State of New Mexico Commerce and Industry Department furnished data for 1980. More recent data are not available. The 1981 and 1982 figures are CBO estimates based on activity in other states.
New York	Data were provided by the State of New York Department of Commerce. The 1982 total is a preliminary figure.
North Carolina	Data though 1981 were obtained from the State and Local Government Finance Division of the Department of the State Treasurer. The 1982 figure is a CBO estimate based on activity in other states.
North Dakota	Data are from the North Dakota Economic Development Commission. Data for 1981 are not available. The CBO estimate for 1981 is based on North Dakota IRB activity in 1980 and 1982.
Ohio	Data on state approved issues are taken from the annual reports of the Ohio Development Financing Commission. Data on local issues are taken from annual lists provided by the ODFC.
Oklahoma	The Oklahoma Department of Economic Development provided lists of IRB issues that it compiled from Final Offering Statements filed with the Oklahoma Secretary of State. The lists probably understate the level of IRB activity in Oklahoma.
Oregon	Data on both state issues and port authority issues were furnished by the Municipal Bond Division of the State Treasury Department.
Pennsylvania	Data were taken from semiannual volumes of <u>Summary of Loans</u> , published and provided by the Pennsylvania Department of Commerce.

Rhode Island	The Rhode Island Department of Economic Development provided information on IRB issues for 1981 and 1982. The Rhode Island Port Authority and Economic Development Corporation provided data for prior years.
South Carolina	Data were supplied by the Economic Development Division of the State Development Board.
South Dakota	Aggregate data were obtained from the State Planning Bureau. The data were the result of a statewide survey conducted by that office. The 1982 figure is a CBO estimate based on activity in other states.
Tennessee	Aggregate data were supplied by the Industrial Research Section of the Tennessee Department of Economic and Community Development.
Texas	Data were supplied by the Texas Industrial Commission. The Commission was created and began its activities in 1979. Since then, the volume of IRB issues in Texas has grown significantly.
Utah	Data through 1981 were provided by the Utah Industrial Development Division. State officials estimate that 80 percent of the IRBs listed go to closing. The figures shown are adjusted to reflect this percentage. However, the figures shown slightly underestimate IRB activity since state officials estimate that the lists include only 80 to 90 percent of all issues. The 1982 figure is a CBO estimate based on activity in other states.
Vermont	A list of IRB issues was provided by the Vermont Industrial Development Authority.
Virginia	Data come from the Commonwealth of Virginia Division of Industrial Development. The 1982 data are preliminary and do not include issues from all industrial development authorities.
Washington	State legislation permitting the use of IRBs went into effect in January 1982. The Department of Commerce and Economic Development provided a copy of its First Annual Report, "Industrial Revenue Bond Financing in Washington State."
West Virginia	Data for 1981 and 1982 were provided by the Governor's Office of Economic and Community Development. The data are based on a survey of counties and municipalities that issue IRBs and may not reflect total volume. The 1980 figure is a CBO estimate based on activity in other states for that year.

Wisconsin

Data on IRB closings came from the State of Wisconsin Department of Commerce

Wyoming

Data are from the Wyoming Department of Economic Planning and Development. The most recent listing available includes only partial 1981 data and no 1982 data. The 1982 figure is a CBO estimate based on activity in other states.